ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

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"You make the most of your money in a bear market; you just don't realize it at the time."

Shelby Cullom Davis

IN FOCUS: Making Sense of It All

In the midst of a bear market and most likely a recession that is already underway, it is important to distinguish between the stock market and the economy. A recovery in the stock market does not necessarily rely upon a simultaneous resumption of the economy, but rather the expectation that a recovery is on the horizon. A path towards at least a partial and sustainable resurgence of the economy will impact investor confidence and push markets higher even before the economy actually turns the corner.

The stock market is forward-looking and is primarily based on earnings expectations and relative fundamentals. Stocks are also highly sensitive to unexpected events or unanticipated data releases. Economic activity was nearly halted in response to the severity of the COVID-19 pandemic. Further complicating matters was the initial failure by OPEC+ to reach a supply resolution to slumping oil prices. In this case, the stock market began pricing in a recession even before one had been formally declared by the National Bureau of Economic Research. What the stock market requires to move higher is for guidance, news, and/or economic data releases to at least be better than what is already expected today. Having the bar quite low, as it is currently, paves the way for surprises to the upside.

The economy, on the other hand, is measured by numerous indicators surrounding the production and consumption of goods and services. Economists across our largest banking institutions and financial services companies are officially declaring that a recession is now unavoidable, attesting to the fact it is likely already underway. March data is revealing weakness amongst many major indicators, reflecting a time when stay-at-home orders were only just beginning to ramp up across the nation on a state by state basis. Small businesses are highly vulnerable to stay at home orders with limited resources to carry them through periods of limited to zero revenue streams. The number of Americans filing for initial unemployment claims spiked to over 30 million during six weeks. Likewise, consumer confidence fell sharply shaken by market volatility, stay-at-home orders, and worsening employment conditions. The ISM Purchasing Managers Index, ISM Non-manufacturing Index, the Employment Report, and Consumer Confidence all declined, further supporting the notion that a contraction is already underway.

We are encouraged by the massive amount of liquidity that was swiftly supplied by the Federal Reserve. Not only had the Fed cut its benchmark rate by 150 basis points in a series of cuts during March to the 0-.25% range, but they are providing unlimited, open-ended quantitative easing through its vehicles such as Main Street Lending Programs and various other lending facilities including the purchase of corporate and municipal bonds.

Globally, the G20 agreed to inject $5 trillion in liquidity and committed "to do whatever it takes and to use all available policy tools to minimize the economic and social damage from the pandemic, restore global growth, maintain market stability, and strengthen resilience." Global central banks have also taken steps to expand liquidity by providing additional credit flows to households and businesses, among other efforts. The International Monetary Fund and the World Bank Group are working collectively to help countries in need.

Two major questions still remain. When will the economy reopen or at least partially begin to ramp up, and when will the stock market recover? No one knows the timing on either of these for sure, but we do know what is necessary. More wide spread testing availability and fluent sourcing of personal protection equipment are essential to isolate and control the virus. Furthermore, enhanced workspace practices that help lower the risk of infection are necessary to limit/prevent a second wave from occurring once economies are reopened. Continued aggressive policy support is necessary in providing liquidity during this time to help moderate the impact on the labor market.

This particular bear market is event-driven, as opposed to the result of structural or cyclical weakness. Event-driven bear markets generally react swiftly and severely to an unanticipated occurrence as we experienced from the market peak in February. But in the same vein, it may not take as long for the markets to recover, once confidence is restored and there are signs that the economy may be at least partially opening.

CLOSE-UP: The Economic Landscape as the Second Quarter Unfolds

As we move beyond April, there is evidence that the COVID-19 virus is peaking in some states hardest hit by the virus followed by the opening of some states beginning in May. Investors should be aware that the openings will be gradual in three medically-designed stages to mitigate the recurrence of the virus. The hardest hit states are those with large metropolitan cities with high density populations, such as New York and Los Angeles, whereas states that are mainly rural had considerably lower mortality rates. As a result, the openings will be staggered and gradual and, in our estimation, will have a similar effect on the economy. While Americans are hardworking and entrepreneurial, the nature of the virus and our response to it will most likely result in a U-shaped recovery as opposed to a V-shaped one. In our opinion, it is not likely that the global economy will return to normal until a vaccine for the COVID-19 virus is developed, with Phase III testing as early as late fall or early winter according to Dr. Anthony Fauci, Director of the National Institute of Allergies and Infectious Diseases.

Unfortunately, the shock of the virus caused a severe financial panic with equities falling 34% from their highs, as the S&P 500 Index reached 3,386.15 on February 19th and then hit the low on March 23rd of 2,237.40. Since then, a 30.2% rally has occurred as of the end of April, although the market is still down 14% from its high. In retrospective, the global panic market response to the pandemic has no comparable circumstances except for perhaps the Spanish Flu of 1918 that killed approximately 675,000 American citizens among a population of close to 100 million. At the start of the current outbreak, equities traded about 14% above their medium multiple levels seen during the low and stable inflation regime, unlike prior pandemics which occurred when equity valuations were at or below median levels, according to a Robert Schiller Study, and confirmed by the Standard and Poor's and Bloomberg. This could be a possible explanation for the rapidity of the market decline.

According to our sources, the stock market actually increased 10.5% in 1918 based on a Dow average of only 20 stocks - but the P/E ratio was 8 times earnings as opposed to 21 times (2020 earnings is based on 2019 earnings of $163 per share). In most respects, the comparison is problematic because American life is so different today than back in the early 20th century. Nevertheless, following a severe recession that started in 1920, an economic boom occurred that is often referred to as "The Roaring Twenties".

In contrast, the financial panic that just occurred followed an 11-year economic boom with unemployment reaching a 50 year low of 3.5% in February. The government's response to the COVID-19 virus was to shut down the economy to save lives thereby creating what may resemble an economic depression, at least on a temporary basis. At present, there are 30 million unemployed workers after six weeks of a shut down. The workforce was just short of 160 million employed within a population of 330 million prior to the pandemic. It is believed by a majority of economists that second quarter GDP will be approximately minus 20-25%, with April being the bottom of the economic cycle.

At present, economists are forecasting GDP growth of -2.9% in the U.S., -5.9% in the E.U., -4.7% in Britain, -1.6% in Japan and +1.0% in China for 2020 (China just reported minus 6.8% for the quarter). China however, is the first economy to have opened up completely. January and February economic statistics were very strong in the U.S. and were followed by the collapse in March. First quarter growth declined 4.8% over the prior quarter, or flat year-over-year. Since this pandemic has shut down the U.S. economy, with unique monetary and fiscal responses, we are somewhat skeptical of most economic forecasts for 2020 at this juncture.

The depression-like conditions caused by the economic shut down led to the Federal Reserve's extraordinary response in providing financial liquidity through the purchase of U.S. Government Treasury bonds or short-term money funds. In addition to a TARP program, similar to the response to the 2008 Great Recession, the Federal Reserve added corporate bond and junk bond exchange traded securities to their buying program. The Treasury will also provide $35 billion of credit protection to the Federal Reserve for the Municipal Liquidity Facility using funds appropriated by the Cares Act. Altogether the balance sheet of the Federal Reserve that was $4.8 trillion before the financial crisis is expected to reach $9-10 trillion 18 months out. There has never been the printing of money of this magnitude except perhaps in Germany during WWI.

Inflation: An Historical Perspective

It's helpful to revisit the origins of the inflation during World War I, to determine if there are any similarities between that catastrophic time and the COVID-19 virus that we are confronting today. Reflecting on what happened following Germany's phenomenal rise to the rank of an industrial world power and a member of the economic world community is a helpful exercise since it abruptly ended in 1914 as the great war unfolded. Of course, the first world war convulsed the entire globe, but the dramatic upheaval of the economic, social and political structure was so fundamental and long-lasting in Germany.

The emergence of Germany as an economic powerhouse was aggravated by the tremendous task of providing the resources to fight the greatest war ever fought in history - and to go it alone without outside financial assistance. The opposing industrial nations were able to call on the greatest economic potential, the United States. The expense of the war was so astronomical along with reparations that many historians believe it ultimately resulted in hyperinflation, caused the eventual rise of National Socialism, and was the inevitable basis for the second world war.

Of course, if one believes that a global pandemic has similar corollaries to a world war, these events always lead to hyper-inflation. Today at annual 3-month rates, the money supply, as measured by M-1, is growing at 18.7% and M-2 by 27.5%. At present, the deflationary effects of the shutdown have no doubt dramatically lowered the velocity of money. It will therefore be very important for the Fed Reserve to wind down these programs as quickly as possible when the economy starts to improve, as they did after the expansion of liquidity during the Great Recession of 2008.

The last major inflation era in the U.S. was the 1970s, triggered by unique factors that we believe do not currently exist. Our lack of confidence that this period serves as a useful guide to future risks is mainly because the 1970s inflation outbreak was followed by the sharp depreciation of the U.S. dollar and two major commodity price shocks that drove up food and energy inflation. That is not the case today. Keep in mind that easy monetary policy allowed initial relative price shocks to pass-through into generalized inflation and rising inflationary expectations. Labor market forces enabled employee compensation to quickly catch-up to past inflation, helping to reinforce underlying price pressures. We believe that wage-inflation correlation is a much less effective measuring guide today in forecasting future inflation, and the near-term threat from the COVID-19 crisis creates more deflationary tendencies. However, the policy response and prior underlying conditions does tilt the odds toward higher inflation in the coming years and bears monitoring.

LOOKING AHEAD:

During the past several months, the U.S. Treasury acted massively to counter the harmful effects of the economic shut down - setting up a series of programs to aid the unemployed and small businesses that have had to close. The Federal budget deficit that was almost at $1 trillion in fiscal 2019 is expected to reach $4 trillion in fiscal 2020, by the time all the various phases of aid have been completed. Nevertheless, one can conclude that between the Federal Reserve and the Treasury, a maximum of aid has been quickly applied to the financial and economic challenges associated with addressing the pandemic. In response to this policy shift, we have revised our real GDP outlook. The projected growth rate for Q2 is so weak that we conclude that this depression-like recession might only last just two quarters (Q1 and Q2), with real GDP growing again during Q3 and Q4. We are revising our real GDP forecast which anticipates a drop of as much as 30% during Q2. We are now expecting a rebound of 15-20% during Q3, and a possible advance of as much as 5% during Q4. This would place results for Q3 in positive territory at this juncture.

Our forecast would take real GDP by the end of this year to $18.2 Trillion or 5.0% below the record high of $19.2 Trillion. Our best estimate of growth in 2021 is close to the 4.0% rate and would still place us below the 2019 peak. We are keeping the inflation rate at 2.0% for 2020 and expect a decline of 17% in earnings. More importantly for investors, however, will be monitoring the future monthly statistics to see how quickly the economy recovers and then forecasting what the results will be for 2021. If it is truly a U-shaped recovery, this will be a prolonged process.

No one has a crystal ball. And economics is not a hard science. It's all a matter of assessing the most likely outcome. In our view, the pandemic will eventually dissipate – and in the interim, the monetary and fiscal measures will tide over the U.S. economy. Furthermore, U.S. policy makers are likely to act expeditiously if additional measures are needed, as suggested by Secretary of Treasury Steve Mnuchin and Congressional leaders.

As we've indicated in previous commentaries, we believe that the virus-induced decline in stocks has made them attractive enough to begin gradually increasing exposure. Our optimistic view has been based on reasonable equity valuations, robust fiscal and monetary policy responses, and the forward-looking nature of equities in the face of a relatively short-lived recession.

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